Asset Allocation Spotlight

...And the bear has arrived

- U.S. equity markets entered bear market territory last week as the novel coronavirus (COVID-19) fueled rapidly rising economic and market headwinds.
- Historically, diversified portfolios have helped investors weather equity volatility and often have recovered to a recent market peak more quickly than individual asset classes (e.g., equities) have done.

Just two short months ago, our investment strategy committee was contemplating what risks could take down the enduring market climb that had led to the longest bull market on record—and then China reported a new virus strain that was sickening its citizens at an alarming rate. Not to worry, many investors reasoned, this new virus likely will die out before crossing the globe to more developed countries in Europe and the U.S., that most surely have the tools to deal with this type of menace.

But that thinking proved too optimistic as the rapid spread, coupled with the virulence of COVID-19, led to downgrades of 2020 global growth and market performance forecasts. Bond yields tumbled to their lowest rates on record, and on March 11, the World Health Organization announced that the COVID-19 virus had become a global pandemic. This announcement—while highly telegraphed—nevertheless led to a renewed round of selling in global markets. Moreover, uncertainty about the possible fiscal policy countermeasures that U.S. policymakers were contemplating also contributed to the sell-off.

On March 11, the Dow Jones Industrial Average closed with a decline of more than 20% from its all-time high on February 12, 2020, marking the start of a new bear market. The S&P 500 Index followed suit on March 12 (the S&P 500 Index reached its all-time high on February 19, 2020).

No one knows for sure how long and how deep this bear market may be, but a look back at previous bear markets gives us some historical context. Since 1929, bear markets have averaged about 20.1 months in duration and have been reflected in an average S&P 500 Index decline of just over 39%.
It is important to note that Wells Fargo Investment Institute’s (WFII) investment objective allocations carefully weigh potential market volatility risk against the potential for long-term growth in the value of the portfolio. The goal is to construct a mix of asset classes that is designed to provide a path of expected returns calibrated to the volatility risk an investor is willing to assume. In other words, investment allocations are designed to match specified risk and return objectives.

As Chart 1 shows, our strategic allocations employ exposure to equities for the potential for long-term growth and exposure to fixed income for the potential for stability and income generation. Some allocations also may include hedge funds for the diversification benefits that they may provide to qualified investors. In today’s volatile market environment, asset allocations that favor fixed income have been faring much better than those that favor equities. This is in contrast to last year’s returns and the returns we expect for a full market cycle (a full bull market and a full bear market).
As Chart 2 illustrates, financial markets can be extremely volatile on a short-term basis, and some investors may be unable to tolerate sizable drawdowns in their portfolios. One way to participate in the financial markets, while potentially minimizing wild swings in investment portfolios, is through asset allocation. Having exposure to a diversified mix of asset classes that do not always move in the same direction historically has provided some downside risk mitigation.

Sources: Morningstar Direct and Wells Fargo Investment Institute, March 11, 2020. WFII portfolio returns are shown in the gold bars—individual asset classes are in the blue bars. Performance results for the WFII 3AG (three asset group) portfolios are hypothetical and presented for illustrative purposes only. Index returns do not represent investment performance or the results of actual trading. Index returns reflect general market results, assume the reinvestment of dividends and other distributions, and do not reflect deduction for fees, expenses, or taxes applicable to an actual investment. An index is unmanaged and not available for direct investment. Hypothetical and past performance does not guarantee future results. Please see the end of this report for portfolio compositions, index definitions, and risks associated with the representative asset classes.

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Note that most fixed income and equity asset classes have performed very differently from one another in this environment. This is why diversification can help—holding a mix of assets has mitigated some of the downside risk from the equity markets in this environment.

As shown in Chart 3, while the year-to-year historical returns of a diversified allocation (represented by WFII’s Moderate Growth and Income 4AG Portfolio) have varied widely; yet the rolling 10-year returns have been far more consistent.

**Chart 3. Annual returns of a diversified portfolio allocation are more volatile than 10-year returns**

Sources: Morningstar Direct and Wells Fargo Investment Institute. Data: December 31, 1989-December 31, 2018. Performance results for the Moderate Growth and Income Four Asset Group Portfolio are hypothetical and for illustrative purposes only. Index returns do not represent investment performance or the results of actual trading. Index returns reflect general market results; assume the reinvestment of dividends and other distributions; and do not reflect deductions for fees, expenses, or taxes applicable to an actual investment. An index is unmanaged and not available for direct investment. Hypothetical and past performance is no guarantee of future results. Please see the end of this report for portfolio composition, index definitions, and risks associated with the representative asset classes.

Diversification also has allowed for shorter recovery times, meaning that historically it has not taken as long to get back to the previous peak after markets fall. Chart 4 highlights periods throughout the past 40 years in which the S&P 500 Index has entered a correction or bear market territory. The chart also shows how a diversified allocation generally has not experienced losses that are as sharp as those of an all-equity position during equity market drawdowns.
**Chart 4. Diversification may reduce downside risk during a correction or bear market**

Sources: Morningstar Direct and Wells Fargo Investment Institute, as of March 11, 2020. Performance results for the Moderate Growth and Income 3AG Portfolio is hypothetical and is presented for illustrative purposes only. Index returns do not represent investment performance or the results of actual trading. Index returns reflect general market results, assume the reinvestment of dividends and other distributions, and do not reflect deduction for fees, expenses or taxes applicable to an actual investment. An index is unmanaged and not available for direct investment. Hypothetical and past performance does not guarantee future results. Please see the end of this report for portfolio compositions, index definitions, and risks associated with the representative asset classes. Note: Corrections are declines of 10% or more. Bear markets are declines of 20% or more.

Attempting to reduce downside volatility can be critical to long-term performance, as it can allow a portfolio to recover much more quickly after a negative market event. Using the same corrective periods from Chart 4 (with the exception of the current drawdown), we examined how long it took to recover to the prior peak. Table 2 shows that, on average, a diversified allocation recovered faster (at just under two years for a bear market) than the S&P 500 Index after corrections and bear markets (which recovered in about 3.5 years from a bear market).

**Table 2. Corrections and bear markets—length of time to recover to previous peak**

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<thead>
<tr>
<th></th>
<th>Corrections</th>
<th>Bear Markets</th>
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<tbody>
<tr>
<td></td>
<td>Days to reach previous peak</td>
<td>Months to reach previous peak</td>
</tr>
<tr>
<td>S&amp;P 500 Index</td>
<td>229</td>
<td>8</td>
</tr>
<tr>
<td>MGI 3AG</td>
<td>201</td>
<td>7</td>
</tr>
</tbody>
</table>

Source: Wells Fargo Investment Institute, March 12, 2020. Corrections are declines of 10% or more. Bear markets are declines of 20% or more. Performance results for the Moderate Growth and Income 3AG Portfolio is hypothetical and is presented for illustrative purposes only. Index returns do not represent investment performance or the results of actual trading. Index returns reflect general market results, assume the reinvestment of dividends and other distributions, and do not reflect deduction for fees, expenses or taxes applicable to an actual investment. An index is unmanaged and not available for direct investment. Hypothetical and past performance does not guarantee future results. Please see the end of this report for portfolio compositions, index definitions, and risks associated with the representative asset classes.

Although downside events have typically been short-lived, how investors react (or don’t react) can be extremely important in meeting long-term financial goals. We have offered guidance for shorter-term tactical adjustments to WFII’s strategic allocations that we believe can help to reduce risk and improve overall return. For fixed-income portfolio positioning, we were favorable on duration (a measure of a bond’s interest rate sensitivity) positioning last year and early in 2020, which benefited the allocations’ performance (we recently moved to a neutral duration position given the yield decline and we retain our high-quality bias in fixed income). In equities, we also have continued to stress our preference for quality equity classes and sectors. We currently favor U.S. over international...
equity markets and large- and mid-cap equities over small caps. We favor commodities at current levels. In addition to our unfavorable guidance on small caps, we are unfavorable on Emerging Market Equities and Developed Market (ex-U.S.) Equities today. From an equity sector standpoint, we hold an unfavorable view of Industrials, Energy, and Materials. We prefer Information Technology, Communication Services, Consumer Discretionary, and Financials at current prices.

We believe that the best investment approach is to set a strategic asset allocation that represents an investor’s goals, risk tolerance, and time horizon—and to rebalance back to those strategic targets on a regular basis. Trying to time the market during periods of heightened volatility is nearly impossible. Yet, investors may want to consider employing tactical asset allocation to make modest adjustments to portfolio allocations based on a nearer-term outlook. These actions may assist in reducing downside risk and could help a portfolio to recover more quickly after negative market-moving events.
Risk Considerations

Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

Asset allocation and diversification cannot eliminate the risk of fluctuating prices and uncertain returns and does not guarantee profit or protect against loss in declining markets.

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. Stock markets, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. Foreign investing has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. Small- and mid-cap stocks are generally more volatile, subject to greater risks and are less liquid than large company stocks. Bonds are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. High yield (junk) bonds have lower credit ratings and are subject to greater risk of default and greater principal risk. The commodities markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. Real estate has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Communication services companies are vulnerable to their products and services becoming outdated because of technological advancement and the innovation of competitors. Companies in the communication services sector may also be affected by rapid technology changes; pricing competition, large equipment upgrades, substantial capital requirements and government regulation and approval of products and services. In addition, companies within the industry may invest heavily in research and development which is not guaranteed to lead to successful implementation of the proposed product. Risks associated with the Consumer Discretionary sector include, among others, apparel price deflation due to low-cost entries, high inventory levels and pressure from e-commerce players; reduction in traditional advertising dollars, increasing household debt levels that could limit consumer appetite for discretionary purchases, declining consumer acceptance of new product introductions, and geopolitical uncertainty that could affect consumer sentiment. The Energy sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions. Investing in the Financial services companies will subject an investment to adverse economic or regulatory occurrences affecting the sector. There is increased risk investing in the Industrials sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation and government regulations, among other things, all of which can significantly affect a portfolio’s performance. Materials industries can be significantly affected by the volatility of commodity prices, the exchange rate between foreign currency and the dollar, export/import concerns, worldwide competition, procurement and manufacturing and cost containment issues. Risks associated with the Technology sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks, especially smaller, less-seasoned companies, tend to be more volatile than the overall market.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund’s offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Portfolio compositions

<table>
<thead>
<tr>
<th>Moderate Income Three Asset Group portfolio</th>
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<tbody>
<tr>
<td>3% Bloomberg Barclays U.S. Treasury Bills (1–3 Month) Index</td>
<td>19% Bloomberg Barclays U.S. Aggregate 1–3 Year Bond Index</td>
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<tr>
<td>7% Bloomberg Barclays U.S. Aggregate 10+ Year Bond Index</td>
<td>6% Bloomberg Barclays U.S. Corporate High Yield Bond Index</td>
</tr>
<tr>
<td>12% S&amp;P 500 Index</td>
<td>5% Russell Mid Cap Index</td>
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<tr>
<td>4% MSCI EAFE Index</td>
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**Moderate Growth and Income Three Asset Group portfolio:** 3% Bloomberg Barclays U.S. Treasury Bills (1–3 Month) Index, 4% Bloomberg Barclays U.S. Aggregate 1–3 Year Bond Index, 21% Bloomberg Barclays U.S. Aggregate 5–7 Year Bond Index, 7% Bloomberg Barclays U.S. Aggregate 10+ Year Bond Index, 6% Bloomberg Barclays U.S. Corporate High Yield Bond Index, 5% JPM EMBI Global Index, 21% S&P 500 Index, 12% Russell Mid Cap Index, 8% Russell 2000 Index, 6% MSCI EAFE Index, 7% MSCI Emerging Markets Index.

**Moderate Growth Three Asset Group portfolio:** 2% Bloomberg Barclays U.S. Treasury Bills (1–3 Month) Index, 2% Bloomberg Barclays U.S. Aggregate 1–3 Year Bond Index, 6% Bloomberg Barclays U.S. Aggregate 5–7 Year Bond Index, 3% Bloomberg Barclays U.S. Aggregate 10+ Year Bond Index, 3% Bloomberg Barclays U.S. Corporate High Yield Bond Index, 3% JPM EMBI Global Index, 29% S&P 500 Index, 16% Russell Mid Cap Index, 13% Russell 2000 Index, 10% MSCI EAFE Index, 13% MSCI Emerging Markets Index.

**Moderate Growth and Income Four Asset Group portfolio:** 3% Bloomberg Barclays U.S. Treasury Bills (1–3 Month) Index, 16% Bloomberg Barclays U.S. Aggregate 5–7 Year Bond Index, 6% Bloomberg Barclays U.S. Aggregate 10+ Year Bond Index, 6% Bloomberg Barclays U.S. Corporate High Yield Bond Index, 5% JP Morgan EMBI Global Index, 20% S&P 500 Index, 10% Russell Midcap Index, 8% Russell 2000 Index, 6% MSCI EAFE Index, 5% MSCI Emerging Markets Index, 3% HFRI Relative Value Index, 6% HFRI Macro Index, 4% HFRI Event Driven Index, 2% HFRI Equity Hedge Index.

**Definitions**

An index is unmanaged and not available for direct investment.

**U.S. Taxable Investment Grade Fixed Income**: Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based measure of the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market.

**Short Term Taxable Fixed Income**: Bloomberg Barclays U.S. Aggregate 1-3 Year Bond Index is the one to three year component of the Barclays US Aggregate Index, which represents fixed-income securities that are SEC-registered, taxable, dollar-denominated, and investment-grade.

**Intermediate Term Taxable Fixed Income**: Bloomberg Barclays U.S. Aggregate 5-7 Year Bond Index is composed of the Bloomberg Barclays US Government/Credit Index and the Bloomberg Barclays US Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of 5-7 years.

**Long Term Taxable Fixed Income**: Bloomberg Barclays U.S. Aggregate 10+ Year Bond Index is composed of the Bloomberg Barclays US Government/Credit Index and the Bloomberg Barclays US Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of 10 years or more.

**High Yield Taxable Fixed Income**: Bloomberg Barclays U.S. Corporate High-Yield Index covers the universe of fixed-rate, non-investment-grade debt.

**Cash Alternatives/Treasury Bills**: Bloomberg Barclays U.S. Treasury Bills (1–3M) Index is representative of money markets.

**U.S. Treasury**: Bloomberg Barclays U.S. Treasury Index includes public obligations of the U.S. Treasury with a remaining maturity of one year or more.

**U.S. Municipal Bond**: Bloomberg Barclays Municipal Index is considered representative of the broad market for investment grade, tax-exempt bonds with a maturity of at least one year.

**Commodities (BCOM)**: Bloomberg Commodity Index is comprised of 23 exchange-traded futures on physical commodities weighted to account for economic significance and market liquidity.

**Public Real Estate**: FTSE EPRA/NAREIT Developed Index is designed to track the performance of listed real-estate companies and REITs in developed countries worldwide.

**Developed Market Ex-U.S. Fixed Income (Unhedged)**: J.P. Morgan GBI Global ex-US Index (Unhedged) in USD is an unmanaged index market representative of the total return performance in U.S. dollars on an unhedged basis of major non-U.S. bond markets.

**Relative Value**: HFRI Relative Value (Total) Index. Strategy is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative or other security types. Fixed income strategies are typically quantitatively driven to measure the existing relationship between instruments and, in some cases, identify attractive positions in which the risk adjusted spread between these instruments represents an attractive opportunity for the investment manager. RV position may be involved in corporate transactions also, but as opposed to ED exposures, the investment thesis is predicated on realization of a pricing discrepancy between related securities, as opposed to the outcome of the corporate transaction.

**Macro**: HFRI Macro (Total) Index. Encompass a broad range of strategies predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard-currency, and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top-down and bottom-up theses, quantitative and fundamental approaches and long- and short-term holding periods. Although some strategies employ RV techniques, Macro strategies are distinct from RV strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments rather than on realization of a valuation discrepancy between securities. In a similar way, while both Macro and equity hedge managers may hold equity securities, the overriding investment thesis is predicated on the impact movements in underlying macroeconomic variables may have on security prices, as opposed to EH, in which the fundamental characteristics on the company are the most significant are integral to investment thesis.

**Event Driven**: HFRI Event Driven (Total) Index. Maintains positions in companies currently or prospectively involved in corporate transactions of a wide variety including mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments.
Security types can range from most senior in the capital structure to most junior or subordinated and frequently involve additional derivative securities. Exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company-specific developments. Investment theses are typically predicated on fundamental (as opposed to quantitative) characteristics, with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

**Equity Hedge: HFRI Equity Hedge (Total) Index.** Equity Hedge: Investment Managers who maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. EH managers would typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities, both long and short.

**Note:** While the HFRI Indices are frequently used, they have limitations (some of which are typical of other widely used indices). These limitations include survivorship bias (the returns of the indices may not be representative of all the hedge funds in the universe because of the tendency of lower performing funds to leave the index); heterogeneity (not all hedge funds are alike or comparable to one another, and the index may not accurately reflect the performance of a described style); and limited data (many hedge funds do not report to indices, and, therefore, the index may omit funds, the inclusion of which might significantly affect the performance shown. The HFRI Indices are based on information hedge fund managers decide on their own, at any time, whether or not they want to provide, or continue to provide, information to HFRI Asset Management, L.L.C. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways. Returns of the underlying hedge funds are net of fees and are denominated in USD.

**Developed Market Ex-U.S. Equities (U.S. dollar)/(Local).** MSCI EAFE Index is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada.

**Emerging Market Equities (U.S. dollar)/(Local).** MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of 23 emerging markets.

**Frontier Market Equities (U.S. dollar)/(Local).** MSCI Frontier Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of 24 frontier (least developed) markets.

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**U.S. Large Cap Equities.** S&P 500 Index is a capitalization-weighted index calculated on a total return basis with dividends reinvested. The index includes 500 widely held U.S. market industrial, utility, transportation and financial companies.

**U.S. Mid Cap Equities.** Russell Midcap Index measures the performance of the mid-cap segment of the U.S. equity universe.

**U.S. Small Cap Equities.** Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

**Dow Jones Industrial Average** is an unweighted index of 30 “blue-chip” industrial U.S. stocks.

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